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EU Prudential Banking Package 2021- get ready for significant changes

The European Commission has published a legislative package containing significant proposals to the existing EU prudential framework concerning (among other things): third country branches; Fundamental Review of the Trading Book; credit risk; and the Fit and Proper framework. This briefing takes a look at the main details.

WHAT?

- a proposed Directive to amend the Capital Requirements Directive (CRD 6);
- a proposed Regulation to amend the Capital Requirements Regulation (CRR III); and
- a proposed Regulation to amend the Capital Requirements Regulation and BRRD in the area of resolution.

WHY?

- The EU wants to complete the outstanding Basel III reforms agreed at international level, as well as address shortcomings found in the existing EU prudential framework.
- In June 2021, the EBA published a report on third country branches setting out a number of recommendations. The European Commission has noted increasing use of third country branches to access Member States' banking markets. The European Commission considers that these entities are in some cases subject to only high-level information requirements and not to consistent EU- level prudential standards or supervisory cooperation arrangements, thus offering opportunities for regulatory and supervisory arbitrage.
- In 2019, the Basel Committee made revisions to its revised market risk standards, known as the Fundamental Review of the Trading Book (FRTB). This was published too late for the EU to incorporate into EU CRR II proposals and it was agreed that the EU would implement the FRTB standards in the CRR II only for reporting purposes.
- The European Green Deal and new Sustainable Finance Strategy set out possible changes to bank regulation to aid transition to sustainable economy and the importance of integrating ESG risks.

WHICH?

The 2021 EU Prudential Banking Package introduces significant proposals in a number of areas including:

Credit risk

Proposals in this area include amendments to reflect changes made to the standardised approach for credit risk (SA-CR) by the Basel Committee in relation to determining the exposure value of off-balance sheet items and commitments on off-balance sheets. Other proposals include; aligning the classification of retail exposures under SA-CR with the classification under the Internal Ratings Based approach so as to ensure consistent application of risk weights to the same set of exposures; introducing more granularity in relation to the risks posed by different types of real estate transactions and loans; and amendments to implement the revised treatment for equity exposures under the final Basel III standards.

Credit risk mitigation

Proposals in this regard include clarifications on the eligibility criteria for guarantees and guarantees provided in the context of mutual guarantee schemes. These clarifications are intended to provide clarity on the eligibility of credit risk mitigation techniques of COVID 19 public guarantee schemes

FRTB

Proposals include an amendment to clarify the definition of a trading desk; revising the criteria used to assign positions to the trading book or the banking book; a derogation permitting institutions to assign to the banking book specific instruments that would otherwise be assigned to the trading book (subject to certain conditions and to approval from the NCA);a derogation to allow firms to create a dedicated trading desk where they can allocate exclusively non-trading book positions subject to foreign exchange risk and commodity risks; and introducing binding own funds requirements for market risk based on the FRTB approaches; introducing alternative qualitative requirements relating to validation, documentation and

governance of the alternative standardised approach.

Credit Valuation Adjustment

Proposals include: introducing a definition of the meaning of CVA risk to encompass both the credit spread risk of an institution's counterparty and the market risk of the portfolio of transactions traded by that institution with the counterparty; provisions clarifying which securities financing transactions are subject to the own funds requirements for CVA risk (including EBA mandates to issue RTS); introducing general requirements for using the standardised approach for calculating the own funds requirements for CVA risk, as well as the definition of regulatory CVA in this regard; introducing a basic approach for calculating own funds requirements for CVA risks, in line with Basel III; and introducing a simplified approach for calculating own funds requirements for CVA risk, as well as eligibility criteria for the use of the simplified approach.

Securities Financing Transactions

The proposals include a mandate for the EBA to report, in cooperation with ESMA, on adoption of the FSB recommendations for introduction of minimum collateral haircuts for some non-centrally cleared SFT trades between banks and non-banks.

Operational risk

CRR III introduces a new standardised approach to replace all existing approaches for operational risks (firms can still use models for the purpose of the internal capital adequacy assessment process). This follows the introduction by the Basel Committee of a single non-model based approach for calculating own fund requirements. Part Three, Title III of the CRR is to be replaced and harmonised with definitions relating to operational risk to be introduced.

ESG

Disclosures on exposures to ESG risks are to apply to all institutions (i.e. not just large, listed ones as is currently the case), in a proportionate way. CRR III accelerates the deadline for the EBA to report on the potential prudential treatment of ESG exposures from 2025 to 2023. CRR III introduces harmonised definitions for environmental risks, social risks, governance risks. Institutions will be required to have robust governance arrangements and concrete plans signed off by the management body to deal with ESG risks.

Prudential treatment of cryptoassets

CRR III provides that the European Commission should review whether a dedicated prudential treatment for cryptoassets would be needed and to adopt if appropriate legislative proposals, taking into account the work of the Basel Committee (which issued a consultation on the topic earlier this year).

Fit and Proper Test

Under the existing Fit and Proper framework, banks' board members and managers are required to demonstrate that they have necessary qualities to exercise their duties. Proposed amendments include: requiring that board members will not be able to take up their positions until firms check if they have the qualities necessary to perform their duties; for large banking groups, prior assessment is to be carried out by national competent authorities in relation to board members with roles in holding companies of banking groups; and a requirement for

institutions to assess “key function holders" to ensure they have all the relevant qualities needed to carry out their functions.

Third Country Branches

Classification

The proposals introduce a new regime for TCBs whereby TCBs are categorised as Class 1 (larger and riskier) and Class 2 (smaller) with requirements adjusted accordingly.

The proposed regime acknowledges that, while subjecting TCBs to the full set of prudential and supervisory requirements under CRR and CRD would be too burdensome, a consistent framework made of the elements stated below is required for TCBs at an EU level.

A TCB will be deemed Class 1 if either of the following criteria is met:

- the total value of the assets booked by the third country branch in the Member State is equal to or higher than EUR 5 billion;
- the third country branch’s authorised activities include taking deposits and other repayable funds from retail customers; and
- the third country branch is not a "qualifying branch" CRD 6 (e.g. if the firm's head office's state has prudential standards and supervisory oversight framework deemed equivalent to CRR and CRD; and is not listed as a high risk third country with strategic deficiencies in its regime on AML/CTF).

Reauthorisation

TCBs must meet certain conditions for authorisation and the minimum regulatory requirements such as: capital endowment requirements (to be maintained at all times); liquidity requirements (depending on the classification of the TCB as Class 1 or Class 2); internal governance and risk control requirements; booking arrangements requirements (to track assets and liabilities linked to the business carried out by the TCB in a Member State); and reporting requirements. All existing TCBs are required to be reauthorised following a 12 months transitional period from transposition.

Power to subsidiarise

NCAs can require TCBs established in their territory to apply for authorisation as a subsidiary under the CRD where the TCB engages in transactions or business with counterparts in other Member States in contravention of the internal market rules. The power is also available for use in cases where a TCB poses risks to the financial stability of the relevant Member State or of the EU.

Assessment of systemic importance and restructuring

Where TCBs have assets on their books in an amount equal to or higher than EUR 30 billion, NCAs must assess on a regular basis whether such TCBs pose a level of risk to the financial stability of the respective Member State and of the EU that is analogous to institutions defined as “systemic” under the CRR and the CRD. NCAs, after a comprehensive assessment and calculation exercise, may decide either to require the TCBs to restructure their activities or assets so that that they cease to meet the criteria of systemic importance or the EUR 30 billion

threshold; or to impose additional Pillar 2 requirements on the third country group's TCBs and subsidiaries in the EU.

Resolution: MREL

The proposals introduce:

- targeted amendments to the CRR and the BRRD relating to the minimum requirement for own funds and eligible liabilities (MREL);
- a requirement into CRR that intermediate parents along the chain of ownership would have to deduct from their own internal MREL capacity the amount of their holdings of internal MREL eligible instruments, including own funds, issued by their subsidiaries belonging to the same resolution group; and
- amendments to the formula for the calculation of the TLAC/MREL surplus of a subsidiary in the context of the general deduction regime applicable to global systemically important institutions (G-SIIs) with a multiple point of entry resolution strategy to ensure that the formula takes into account both the risk-based and the non-risk-based TLAC/MREL requirements of the subsidiary, in line with the TLAC standard.

WHEN?

The European Commission is proposing that the measures would apply, for the most part, from January 2025.

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